

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

R-717

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

October 19, 1940



Dear Sir:

You will find enclosed copies of two memoranda designated as follows:

- (1) Duties of Advisory Commission under Section 124 of the Internal Revenue Code;
- (2) Analysis of Memorandum Entitled "Duties of Advisory Commission under Section 124 of the Internal Revenue Code".

The first of these memoranda refers to a procedure which has been approved by the National Defense Advisory Commission and the second is an analysis prepared in the office of the General Counsel of the Board of Governors.

These memoranda are sent to you for your information at this time but, pending such announcement as the Commission may make, the information contained therein has not been released for publication.

Very truly yours,

Chester Morrill,
Secretary.

Enclosures 2

TO THE PRESIDENTS OF ALL FEDERAL RESERVE BANKS AND THE
MEMBERS AND SECRETARY OF THE FEDERAL ADVISORY COUNCIL.

DUTIES OF ADVISORY COMMISSION
UNDER SECTION 124 OF THE INTERNAL REVENUE CODE

(Title III, Section 302 of the Second Revenue Act of 1940)

Sections 23 and 124 of the Internal Revenue Code allow a taxpayer a tax deduction for amortization over a 60-month period of facilities constructed or acquired after June 10, 1940, if the facilities are certified by the Advisory Commission to the Council of National Defense and either the Secretary of War or the Secretary of the Navy as necessary in the interest of national defense during the emergency period. This certificate will hereinafter be termed the "Emergency Facilities Certificate". In the event that the entire cost of the construction or acquisition of a particular facility is not necessary, the Commission may certify the percentage of the cost necessary.

Second, if the taxpayer, pursuant to any contract with the United States, has been or will be reimbursed by the United States for the cost of such facilities either (1) directly by a provision dealing expressly with such reimbursement or (2) indirectly, because the price to be paid by the United States is recognized by the contract as including a return of cost greater than normal depreciation, the amortization deduction is not allowed unless the Advisory Commission and either the Secretary of War or the Secretary of the Navy also certify that the contract adequately protects the United States with reference to the future use and disposition of the emergency facilities. This certificate will hereinafter be termed the "Certificate of Government Protection" and is applicable principally to the Emergency Plant Facilities contract.

Third, to conclusively establish that a Certificate of Government Protection is not required, provision is made for certification by the Advisory Commission and either the Secretary of War or the Secretary of the Navy that a contract between the taxpayer and the United States does not reimburse the taxpayer for the cost of facilities either (1) directly, by a provision dealing expressly with such reimbursement or (2) indirectly, because the price to be paid by the United States is recognized by the contract as including a return of cost greater than normal depreciation. This certificate will be termed the "Certificate of Nonreimbursement". Taxpayers who have supply contracts will seek it. It should be noted that this certificate will issue on determination of what reimbursement of cost is recognized by the contract to be included in price. Thus it would seem appropriate to issue a Certificate of Nonreimbursement if a contract for supplies is negotiated in good faith without the intention to include in price a return of cost of facilities greater than normal depreciation.

The operation of the three certificates may be illustrated as follows.

A taxpayer who finances the construction or acquisition of facilities, without seeking reimbursement from the Government is allowed the 60-month amortization deduction if an Emergency Facilities Certificate is secured. When he later contracts with the United States for supplies, such a taxpayer will ordinarily also seek a Certificate of Nonreimbursement. Without such a Certificate the Commissioner of Internal Revenue may thereafter conclude that the price charged was recognized by the contract as including a return of cost greater than normal depreciation, whereupon the amortization deduction will be disallowed for failure to secure the Certificate of Government Protection.

A taxpayer who has an Emergency Plant Facilities Contract is allowed the 60-month amortization deduction if an Emergency Facilities Certificate and a Certificate of Government Protection are secured. To be protected with respect to his supply contract with the United States such a taxpayer will also seek to secure a Certificate of Nonreimbursement.

The amortization deduction is not a tax advantage to a taxpayer who has an Emergency Plant Facilities Contract but only the means by which the taxpayer insures himself against paying income tax on Government reimbursements for plant costs.

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ANALYSIS OF MEMORANDUM ENTITLED "DUTIES OF ADVISORY
COMMISSION UNDER SECTION 124 OF THE INTERNAL REVENUE CODE"

In order that a person, who has constructed or acquired emergency plant facilities in carrying out a contract with the Government, may be allowed a tax deduction for amortization over a 5-year (sixty-month) period, as permitted by the new excess profits tax law, he must obtain certain certificates from the Government. The certificates in question are termed "Emergency Facilities Certificate", "Certificate of Government Protection" and "Certificate of Nonreimbursement". Each of these several types of certificates is addressed to the Commissioner of Internal Revenue and executed by both the Advisory Commission to the Council of National Defense and either the Secretary of War or the Secretary of the Navy.

Emergency Facilities Certificate. - This certificate must be obtained in every case to enable the contractor to avail himself of the tax deduction based on a 5-year amortization of his emergency plant facilities instead of the longer amortization period normally applicable. It certifies that the facilities in question are necessary in the interests of national defense during the emergency period. If the entire cost of the construction or acquisition of a particular facility is not so necessary, the Commission may certify the percentage of the cost necessary.

Certificate of Government Protection. - In addition to the Emergency Facilities Certificate mentioned above, if the United States reimburses the contractor for any part of the cost of the emergency plant facilities, either under direct contract provision to this effect or by inclusion of the cost in the price of the supplies which the contractor is to furnish the Government, he must, in order to be able to amortize the facilities over a 5-year period for tax purposes obtain also a Certificate of Government Protection. This certifies that the contract adequately protects the United States with reference to the future use and disposition of such emergency facilities. In other words, the certificate evidences the judgment of the Advisory Commission to the Council of National Defense and of the Secretary of War and the Secretary of the Navy that by appropriate contract provision the Government will eventually obtain title to the emergency plant facilities or be paid for them by the contractor or is protected in some other adequate way in the future use of such facilities. This certificate is needed only where the Government pays the entire cost of the facilities or pays a part of such cost in excess of normal depreciation.

Certificate of Nonreimbursement. - If reimbursement of cost of the facilities by the Government is not contemplated, either by

direct contract provision or by inclusion of part or all of the cost in the price of the supplies to be furnished the Government, a Certificate of Nonreimbursement in addition to the Emergency Facilities Certificate may be obtained. This certifies the fact that reimbursement of the cost of the facilities by the Government is not provided for and under the law conclusively establishes that a Certificate of Government Protection is not required in order for the contractor to obtain the benefit of the 5-year amortization period for tax purposes. While this certificate is apparently not strictly required in any case, it is desirable for the contractor to obtain it because of its value as conclusive evidence.

Illustrations of Certificates Necessary for
Particular Types of Contracts

(1) If a contractor has contracted with the Government to furnish certain supplies and the contract contemplates that such additional plant facilities as are necessary are to be constructed at the contractor's expense and at no cost to the Government, an Emergency Facilities Certificate and a Certificate of Nonreimbursement are both needed in order that the contractor may amortize the cost of the plant facilities over the 5-year period for tax purposes.

(2) If the contractor has contracted with the Government to furnish certain supplies and also has an Emergency Plant Facilities Contract under which the Government is to pay the cost of the construction or acquisition of plant facilities, the contractor will wish to obtain all three certificates mentioned, in order to have the benefit of the 5-year amortization period. He must, of course, have the Emergency Facilities Certificate because this is necessary in every case to obtain the 5-year amortization; he must have the Certificate of Protection with respect to the Emergency Plant Facilities Contract because of the fact that the Government reimburses him for the cost of the plant facilities; and, with respect to his supply contract as distinguished from the Emergency Plant Facilities Contract, he will also wish to have a Certificate of Nonreimbursement.

(3) If a contractor has contracted with the Government to furnish certain supplies and the price of these supplies includes as one factor the cost of the construction or acquisition of the necessary plant facilities, the contractor must have an Emergency Facilities Certificate and a Certificate of Government Protection in order to obtain the benefit of the 5-year amortization period. The Emergency Facilities Certificate is necessary in every case and the Certificate of Government Protection will be necessary because the Government reimburses the contractor for the cost of the plant facilities. It is understood, however, that there will in the future be few supply contracts which include facilities costs in the price of supplies, as the "Emergency Plant Facilities Contract" will be used instead.

(4) If a contractor has a contract for supplies with no need for any additional plant construction of any kind, it appears that none of these certificates are necessary because they are all related to amortization of the cost of emergency plant facilities completed or acquired after June 10, 1940.